CAN I HAVE A REFUND?

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INTRODUCTION

In *Havila Kystruten AS v Abarca Compania de Seguros AS,*[1] in which WFW represented the successful Norwegian shipowner, an English court has provided helpful and very detailed guidance on a number of issues relating to the parties' rights to terminate shipbuilding contracts as well as the nature and scope of refund guarantees.

BACKGROUND

Refund guarantees are the lifeblood of shipbuilding, providing invaluable security to owners/buyers who must usually cash fund a significant proportion of the price of newbuildings during the construction phase (usually at least 40%), with the balance being paid on completion and delivery of the ship. If the buyer cancels the contract during the construction phase the yard will retain title to and possession of the partially completed ship. Such cancellations usually occur due to the yard's insolvency or failure to complete by the deadline, which often results from the yard being in financial difficulty. Recourse to a creditworthy guarantor is therefore vital for any buyer to obtain a refund of its investment. Sometimes, the yard's breach will be so serious that the buyer may also wish to terminate the shipbuilding contract under its general common law rights by accepting the yard's breach as 'repudiatory'. This might happen where the yard abandons or refuses to continue with the project, for example, following a purported cancellation of the contract.

THE FACTS

The case concerned shipbuilding contracts for construction of two passenger ships intended to perform coastal service in Norway under long-term charters with the Norwegian Ministry of Transport. The dispute arose when the Vigo-based Spanish yard purported to cancel the contracts just two days before petitioning the local Spanish court for its dissolution, no doubt to pre-empt any attempt by the buyer to rely on that filing to cancel the contracts itself. Around three months later, the buyer eventually cancelled the contracts, relying on contractual rights that allowed it to do so where the yard commenced dissolution proceedings and it was established 'beyond reasonable doubt' that the yard would not complete the ships by the 'drop dead' date. The buyer also terminated the contracts at common law, relying on the yard's refusal to continue construction of the ships following its own purported cancellations as a 'repudiatory breach' of the contracts. In the ensuing litigation, both yard and buyer claimed to have been the first party validly to terminate the shipbuilding contracts. The stakes were high because if the buyer won, it would obtain judgment for €36.8m plus interest from the yard and from the refund guarantor, a Portuguese insurance company. If the yard won, it was looking to recover some €50m on top of the €36.8m it had received.

Before the dispute arose, the project had been troubled for some time. Initially, the buyer had planned to integrate a Spanish tax lease scheme[2] into a Chinese financial lease structure. The buyer had no difficulty obtaining a detailed term sheet from a leading Chinese leasing house, but then spent several months over what proved to be complex arrangements, before shelving the double lease concept and approaching different lenders. For its part, the yard pressed ever more vocally for the buyer to get its financing in place. It claimed in the proceedings that the financing had to be in place before an ECA counter-guarantee for issuance of the refund guarantees could be obtained. Many exchanges, meetings and contract addenda followed. In the seventh addenda, the buyer agreed to provide a "*written, committed statement from the bank/financing institution*" by an agreed deadline, failing which the parties were to meet and negotiate over a two-week period. If at the end of that fortnight they concluded that there was no "*other alternative financial arrangement*" to be provided by the buyer, the yard could cancel the contracts. Shortly after this agreement, the buyer paid the next instalments due under the contracts.

Over the course of the next few months, as the deadline for the 'committed statement' was extended, the yard indicated to the buyer that to achieve the shallow draught required for the ships' coastal service, the design needed radical modification, necessitating elongation of the midships section by 10m, at significant extra cost. Whilst the parties wrangled over the changes and price increase, the buyer obtained and tabled a committed statement from a new financier.[3] But the yard denied that the letter sufficed or had been provided in time. Construction of both ships stopped. Ever more heated meetings took place in Spain, Norway and Amsterdam's Schipol airport, in which the parties attempted to renegotiate the technical specifications and the provision of interim funding to restart construction work.

Eventually, the technical changes were agreed in the ninth addenda to the contracts. However, by this time, the yard's financial situation was becoming dire. Unbeknown to the buyer, the yard had incurred cost overruns of some €80m on another project.[4] This required a capital increase of at least €50m that the yard's shareholders were unwilling to provide, according to an article appearing in the local Spanish press. Shortly afterwards, the yard filed for pre-insolvency protection. A number of conditions precedent to the ninth addenda still remained unsatisfied. The yard purported to cancel the contracts on the basis that the committed statement had not been provided and that interim funding allegedly due remained unpaid. Two days later, the yard applied for its judicial dissolution. The tax leases were terminated. The buyer accepted the yard's refusal to revoke its cancellations as a repudiatory breach and cancelled the contracts, shortly before new contracts with a yard in Turkey for construction of the ships became effective. The buyer's evidence was that the first of those ships had since been completed in Turkey and met the draught requirements without design modifications.

THE JUDGMENT

In a detailed 159-page decision, the judge reviewed a large number of factual and legal issues to which a short briefing note can hardly do justice. However, the following findings should be of interest to owners and practitioners alike:

1. The judge accepted that the commitment letter obtained by the buyer was a "committed statement" of finance as required under the seventh addenda. It required: "*a commercial commitment to lend, whereby the bank has given an 'in principle' indication that it will lend on specified terms, but without any binding legal agreement yet having been entered into*". This is exactly what a bank commitment letter is ordinarily understood in the finance sector to be. The judge accepted the evidence of the buyer's former CEO that the issue by a bank of a term sheet, even if not strictly legally binding, "*in general represents an important degree of commercial commitment to the proposed transaction*";

2. The judge found that that the yard could not itself terminate the contracts unless the parties had concluded, having negotiated in good faith, that there was no alternative financial arrangement to be provided by the buyer sufficient to avoid termination of the contracts. On the facts, the parties had not reached such a conclusion. Further, although the committed statement had been provided after the agreed deadline, the yard had waived any right to terminate on this ground by continuing to negotiate with the buyer, including over modifications to the ships' design;

3. The judge rejected the yard's claim that the additional payments of €5m per ship had fallen due, despite a number of the conditions precedent ("CP") to the ninth addenda not having been met. The yard contended that not all of these CPs applied to the buyer's obligation to pay these sums, but the court disagreed;

4. Nor could the buyer be said to be in repudiatory breach of the contracts, even if it had failed to comply with the terms of the addenda as the yard alleged, especially in circumstances where the buyer was in a position and had expressed itself willing to pay instalments and continue with the project;

5. Having rejected the yard's termination of the contracts, the judge considered the buyer's termination. The yard's primary contention here, undoubtedly intended to assist the refund guarantor's position (discussed below) was that the buyer, having terminated for repudiatory breach, could claim damages only but not restitution of its instalments, because there had not been a total failure of consideration, because there had been substantial construction work.[5] The buyer's answer was that, even were the yard's argument correct, it could recover its instalments by electing to claim for reliance loss instead of expectation loss.[6] The yard nevertheless contended that reliance losses cover only expenditure to third parties and not payments to a contractual counterparty. The judge rejected this and held that any wasted expenditure may be recovered as reliance loss, provided the value of any partial performance is taken into account. The buyer also relied on *Stocznia Gdynia S.A. v. Gearbulk Holdings Ltd,*[7] in which the Court of Appeal had held that a buyer which had terminated a shipbuilding contract for repudiatory breach was entitled to claim both restitution of its prepaid instalments and loss of bargain damages by reason of the total failure of consideration in that case. In *Stocznia*, the buyer had terminated before construction had got underway, which might have explained the Court of Appeal's finding in that case that there had been a total failure of consideration. To counter any suggestion that the case did not apply, the buyer contended that at least some work, such as design or procurement, must have been done in *Stocznia* and further observed that the Court of Appeal had not distinguished between the remedies available to the buyer in respect of one ship, for which steel cutting had been carried out and the two ships for which it had not. The judge determined that he did not need to decide this issue, because the buyer was content to claim reliance loss, rather than restitution of its instalments and loss of bargain damages, recognising that it had no realistic prospect of recovering any sums from an insolvent Spanish yard in excess of its instalments, for which they held refund guarantee security. Finally, the court held that the buyer did not need to show a total failure of consideration to claim reliance losses;[8]

6. The judge upheld the buyer's right to cancel the contracts under a bespoke right exercisable if "*it can be established beyond any reasonable doubt that the Vessel will be delayed*…" beyond the 'drop dead' date. Provisions of this kind are sometimes negotiated into shipbuilding contracts, to enable the buyer to cancel without having to wait for the 'drop dead' date to pass if it becomes obvious that the yard will never complete the ship by that date. But such rights are difficult to exercise with confidence, given the high evidential hurdle of showing that the yard would certainly have missed the 'drop dead' date. But here, the yard itself had purported to terminate the contracts, having ceased construction work months previously and had thereafter ignored the buyer's invitations to it to revoke its purported cancellations;

7. The judge also upheld the buyer's cancellation by reason of the yard having "*commenced*" proceedings for its dissolution. The yard had argued that the Spanish court had later rejected its petition, a rejection claimed to have had retrospective effect under Spanish law, thereby precluding the buyer from relying on the earlier filing. After hearing expert evidence on Spanish law, the judge held that proceedings had been commenced, even if, under the Spanish procedural code, the court could later decide whether or not to admit the claim. Further, the yard's petition had later not been declared inadmissible on grounds of any invalidity but rather by reason of supervening events. As such, the fact that, under Spanish law, the relevant time bar was only interrupted when the petition was admitted did not mean that the claim could be deemed non-existent for all purposes if the claim was later refused admission. The judge went on to hold that, even if his conclusion was wrong, the parties cannot have intended under English law governed contracts for a buyer cancellation to be invalidated or unravelled by subsequent events and that the validity of a cancellation notice must be assessed "*in the light of the circumstances actually in existence when it is served*". Any other approach would give rise to unacceptable uncertainty about the position and scope for serious prejudice to the party who has served the notice. This is an important finding, given that shipbuilding contracts are often cancelled in reliance on insolvencies of foreign counterparties, the precise nature and legal status of which the innocent party may not understand at the time of cancellation;

8. The judge construed the refund guarantees to be demand bonds given that they contained wording that converted them into conditional or 'see to it' guarantees if the yard commenced proceedings to dispute the buyer's cancellations within a fixed period, which the yard had failed to do. In this respect, the judge followed a number of authorities to this effect;[9] and

9. The judge rejected the refund guarantor's submission that the refund guarantees did not respond to a buyer termination at common law for repudiatory breach. Here, the judge noted that the bonds on their face were worded to secure buyer cancellations "*under Article XII (1) of the SBC or termination of the SBC under its applicable law*". The reference to Article XII was to the clause that permitted cancellation on the basis of the express termination events in the contracts. But the reference to terminations under 'applicable law' must be wider. Further, the reference to the refund guarantor's "*obligation … to return the Instalments*" was broad enough to cover an obligation to pay damages in the amount of the instalments. As the judge observed: "*it would be a strange lacuna if the bonds were ineffective if the Yard were, for example, simply to renounce its obligations*" under the contracts".

CONCLUSIONS

The judgment will be welcomed by practitioners for the clarity is has brought to the question of the nature and coverage provided by refund guarantees issued to secure the obligations of shipyards to refund advance instalments on cancellation of shipbuilding contracts. Buyer cancellations of such contracts are not infrequent, as shipbuilding projects often become significantly delayed and the financial health of yards can be precarious in what is a highly competitive industry that services a volatile market sector. The decision puts beyond doubt that refund guarantees expressed to secure repayment of the buyer's instalments can secure a claim in restitution or for reliance loss for such sums following a termination for 'repudiatory breach' at common law and not just an express contractual termination.

For owners, the case illustrates the potential pitfalls involved when attempts are made to rescue troubled newbuilding projects. The owner's willingness to provide advance funding in order for construction to resume ended up being relied on by the yard to manufacture a contractual cancellation claim. Obviously, parties will want to do their utmost to rescue a project for construction of an asset, especially if required for delivery into charter service, as was the case here. But a buyer's understandable desire to get a project back on track may not be entirely aligned with a yard that knows it may forfeit the buyer's instalments and retain possession of the ship if it is able to cancel.

Finally, the facts illustrate the difficulties buyers may face if in doubt as to a yard's financial condition. Here, the buyer did not discover the true state of the yard's finances until shown an article in the local Spanish press. When the facts were revealed and the buyer sought to rely on the yard's application to court for its dissolution as justifying its (i.e. the buyer's) cancellation of the contracts, it was met with abstruse points of Spanish insolvency law that it took a 159 page judgment finally to cut through.

[1] [2022] EWHC 3196 (Comm).
[2] Under which a Spanish tax lessor obtains and shares Spanish capital tax allowances available for ships built in Spain with a lessee/owner.
[3] A well-known leasing house active in the aircraft sector that was keen to diversify into shipping.
[4] For construction of a cruise ship for the Ritz-Carlton group.
[5] The yard relied on *Hyundai Heavy Industries v Papadopoulos* [1980] 2 Lloyd's Rep 1, 13; *Stocznia v Latvian Shipping (No. 1)* [1998] 1 WLR 574, 585-6 (HL); and *Stocznia Gdynia v Gearbulk Holdings* [2009] 1 Lloyd's Rep 461 § 40, in addition to passages in Curtis on Shipbuilding Contracts (pp. 223-224) and Keating on Construction Contracts (11th ed.) § 4-01).
[6] *C&P Haulage v Middleton* [1983] 1 WLR 1461, at 1465-8, in which the Court of Appeal considered the relevant line of authority starting with *Anglia Television Ltd v Reed* [1972] 1 QB 60.
[7] *Stocznia Gdynia SA –v- Gearbulk Holdings Limited* [2009] 1 Lloyd's Rep. 461, per Moore-Bick LJ at [40].
[8] The court cited as authority *Cardiorentis AG v Iqvia* [2022] EWHC 250 (Comm) per Butcher J at [452].
[9] *Meritz v Jan de Nul* [2011] EWCA Civ 827; *WS Tankship II BV –v- The Kwangju Bank Ltd* [2011] EWHC 3103 (Comm.); and *Shanghai Shipyard Co Ltd v Reignwood International Investment (Group) Company Limited* [2021] EWCA Civ 1147.

KEY CONTACTS

CHARLES BUSS
PARTNER • LONDON

T: +44 20 7814 8072

cbuss@wfw.com

LUCAS NAVARRO
SENIOR ASSOCIATE • LONDON

T: +44 2033 146313

LNavarro@wfw.com

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